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No. 79-1907

IN THE

# Supreme Court of the United States

OCTOBER TERM, 1980

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COMMISSIONER OF INTERNAL REVENUE,
*Petitioner,*

v.

PORTLAND CEMENT COMPANY OF UTAH,
*Respondent.*

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**On Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit**

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## BRIEF FOR THE RESPONDENT

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## QUESTION PRESENTED

Whether for purposes of computing the percentage depletion allowance provided under Sections 611 and 613 of the Internal Revenue Code of 1954, an integrated miner-manufacturer of portland cement is entitled to apply the proportionate profits method consistently with the method's fundamental purpose of determining the market value of the crude mineral product, so that the market value will not be distorted either (1) by the inclusion in the formula of bagging services that are applied after the first marketable product is obtained and that do not earn a profit, or (2) by treating selling and other marketing expenses which benefit the entire integrated mining and manufacturing operation as relating solely to the manufacturing activity.

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## BRIEF FOR THE RESPONDENT

### STATUTES AND REGULATIONS INVOLVED

Sections 611 and 613 of the Internal Revenue Code of 1954 (26 U.S.C. §§ et seq.) and Treasury Regulations §§ 1.611-0, 1.613-4 and 1.613-5 (26 C.F.R. §§ et seq.), are set forth in the Appendix, *infra.*

### STATEMENT OF THE CASE

A. *The Proportionate Profits Method*—Under the statutory framework of sections 611, 612 and 613 of the Internal Revenue Code of 1954,[1] the amount of the percentage depletion deduction is a statutory percentage of the market value of the taxpayer's mined mineral, referred to as its "gross income from mining," limited to

[1] All section references are to the Internal Revenue Code of 1954, as amended, 26 U.S.C., et. seq., unless specifically indicated otherwise.

50 percent of its net income from mining.[2] § 613; Reg. § 1.613-1.[3]

Pursuant to section 613(a), a miner's percentage depletion deduction is computed by applying the statutory percentage depletion rate of the mineral that it extracts to its "gross income from the property." Reg. § 1.613-1. With respect to mining, the term "gross income from the property" means income from the actual mining operation, which includes extraction of the ore or mineral from the ground and the application of allowable mining processes. § 613(c)(1)&(2); Reg. § 1.613-4(a).

In the case of minerals that are customarily sold in the form of a crude mineral product, such as coal or iron ore, the miner's gross income from mining—the market value of its mineral—is normally determined by looking to its actual gross receipts from the sales of its mineral products. Reg. § 1.613-4(b). There are other minerals, however, that because of their natural state are not sold in crude form, but are treated by nonmining processes after extraction to obtain a first marketable product. Typically, the miner of such minerals is an integrated miner-manufacturer. To compute the allowable depletion deduction in these cases the miner must determine a constructive gross income from mining—i.e., the market value of its mineral product at the point where, under section 613(c), mining ends and manufacturing begins (the "cutoff point").

When a mineral industry has both unintegrated miners and integrated miners also engaged in manufacturing, the integrated miner-manufacturer must determine the

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[2] The miner is entitled to deduct a proportionate part of its cost basis in the mineral property allocated to the units of production of the mined mineral whenever the cost depletion allowance is greater than the percentage depletion allowance. § 612.

[3] All section references to regulations are to the Treasury Income Tax Regulations, 26 C.F.R., et. seq., unless specifically indicated otherwise.

market value of its mineral at the cutoff point on the basis of the representative market or field price charged by its unintegrated competitors who produce and sell a mineral product of like kind and grade in the same market. Reg. § 1.613-4(c). If there are no miners in a mineral industry who sell their mineral product without performing manufacturing processes, such as in the cement industry, or if a representative market or field price cannot be established for other reasons, the regulations generally require a miner to determine the market value of its mineral—its constructive "gross income from mining"—at the cutoff point under the so-called proportionate profits method:

> If it is impossible to determine a representative market or field price as described in paragraph (c) of this section then, except as provided in subdivision (ii) of this subparagraph, gross income from mining shall be computed by use of the proportionate profits method as set forth in subparagraph (4) of this paragraph. * * *. Reg. § 1.613-4(d)(1)(i).

The mechanics of the proportionate profits method are provided in Reg. § 1.613-4(d)(4)(ii). The method is generally applied by multiplying the miner's gross revenues (actual and constructive) from the sale of its first marketable product by a fraction, the numerator of which is the sum of all costs allocable to mining and the denominator of which is the total of all the mining and nonmining costs incurred to obtain such sales. This computation may be illustrated as follows:

$$\frac{\text{Mining costs}}{\text{Total costs}} \times \text{Gross sales} = \text{Gross income from mining}$$

Thus, the proportionate profits method operates on the premise that the same rate of profit is earned by each

dollar of cost incurred in the mining, manufacture, and sale of the first marketable product.

B. *The Facts of the Case*—Portland Cement Company of Utah (hereinafter PCCU) is an integrated miner-manufacturer of portland cement. It quarries argillaceous limestone rock,[4] known in the trade as cement rock,[5] and processes such rock into finished portland cement. (A. 33; T.C. Memo 1977-137 at p. 2).

Mining operations begin at PCCU's quarry near Salt Lake City. The cement rock is blasted free from the quarry face and pushed by bulldozers to the quarry floor. Secondary blasting, if necessary, reduces the size of large boulders. Jaw crushers and impactors reduce the size of the loose rocks to less than one square inch. The crushed material is then transported to PCCU's processing plant at Salt Lake City. (A. 34; T.C. Memo at p. 2).

At the cement plant, rod-ball mills grind the rock to a powder. Water is added to the powder to form a "slurry," a very fine mud. The slurry is then fed into rotary kilns. (A. 34; T.C. Memo at p. 3).

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[4] Referred to as "calcium carbonate" or "limestone" in Section 613(b)(7), Internal Revenue Code of 1954, subject to a 15 percent depletion rate for PCCU's fiscal year ended March 31, 1970, and a 14 percent depletion rate for fiscal years ended March 31, 1971, and March 31, 1972.

[5] PCCU's cement rock deposit is a rare type which is more valuable and more desirable than other types of limestone for use as a raw material in the manufacture of portland cement. PCCU's argillaceous limestone has the unique constituents of ideal chemical and physical proportion and combination for the manufacture of cement. *Portland Cement Co. of Utah* v. *United States*, unreported decision, Dkt. No. 12-60 (D. Utah 1966), unofficially reported at CCH 66-1 USTC ¶ 9430, at p. 86,026 and P-H 17 AFTR 2d 1028.

The mining phase of PCCU's operation concludes at this point—the "cutoff point." [6] (T.C. Memo at p. 3).

PCCU's manufacturing process begins when the liquid slurry is burned in the rotary kilns. The heat from the kiln expels moisture and converts carbonates into oxides. As the material is heated to an incipient fusion, chemical reactions inside the kiln produce complex silicates and aluminates. This sintering process produces a hard, glass-like "clinker." The clinker is cooled and later ground with purchased gypsum to produce finished portland cement. The finished cement is then placed in storage silos to await sales to customers. (A. 34-35, 67; T.C. Memo at p. 3-4).

PCCU sells most of its cement in bulk, loading it directly from the storage silos into tank trucks. It conveys a small portion of its bulk cement from the storage silo to a bagging machine where it is packaged in paper bags for sales to customers who purchase cement in bags.[7] (A. 67; T.C. Memo at p. 4).

During the taxable years in issue, PCCU incurred costs from its bagging operation and charged its customers a "bag premium" for the service of bagging the finished cement which produced losses attributable to the bagging operations, *per se*, as follows:

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[6] Section 613(c)(4)(F), Internal Revenue Code of 1954. The mining industry in general refers to the "cutoff point" as the point in an integrated mining-manufacturing operation at which allowable mining processes for tax purposes, i.e., the computation of percentage depletion, cease.

[7] During the taxable years in issue PCCU sold approximately 6 to 8 percent of its finished cement in bags. (A. 71). In prior years, PCCU's cement plant sold 6 to 10 percent of its finished cement in bags. (A. 72).

| Fiscal Year Ended | Total Bags and Bagging Costs | Total Bag Premium Revenue | Net Loss From Bagging |
|---|---|---|---|
| March 31, 1970 | $104,547.88 | $49,137.00 | $(55,410.88) |
| March 31, 1971 | 122,845.05 | 56,177.60 | (66,667.45) |
| March 31, 1972 | 129,817.56 | 65,227.15 | (64,590.41) |

(A. 104-108).[8]

During the taxable years in issue, PCCU paid the following amounts of dues to the Portland Cement Association:

| Fiscal Year Ended | P.C.A. Dues |
|---|---|
| March 31, 1970 | $35,268.85 |
| March 31, 1971 | 20,032.85 |
| March 31, 1972 | 18,186.85 |

(A. 37-38).

PCCU also incurred selling expenses, attributable both to the compensation and business expenses of its salesman and to local advertising and promotion, in connection with the marketing of its finished portland cement as follows:

| Fiscal Year Ended | Selling Expenses |
|---|---|
| March 31, 1970 | $47,178.47 |
| March 31, 1971 | 47,345.19 |
| March 31, 1972 | 54,003.63 |

(A. 40).

PCCU incurred shipping and storage expenses in connection with the marketing of its finished portland cement as follows:

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[8] Although the Tax Court noted that the parties had stipulated the amounts of the expenses involved, it did not include such amounts in its Findings of Fact on the assumption that they "would not furnish an aid to an understanding of this case." See T.C. Memo at p. 4, ftnt. 3.

| Fiscal Year Ended | Storing and Shipping Expenses |
|---|---|
| March 31, 1970 | $ 95,594.28 |
| March 31, 1971 | 113,538.53 |
| March 31, 1972 | 118,953.56 |

(A. 39, 106-108).

The general overhead expenses, indirect expenses not identifiable with a particular mining or manufacturing activity, incurred by PCCU in connection with its mining-manufacturing operations conducted to produce portland cement were as follows:

| Fiscal Year Ended | Overhead Expenses |
|---|---|
| March 31, 1970 | $314,255.59 |
| March 31, 1971 | 238,088.71 |
| March 31, 1972 | 420,735.30 |

(A. 39).

PCCU arrives at the Court after approximately twenty years of litigation to resolve the matter of the proper depletion allowance that it is entitled to claim with respect to the cement rock mined at its quarry and manufactured into portland cement. Initially, PCCU contested its taxable years 1954 through 1956 in a protracted case that lasted 12 years and produced five separate decisions by the United States Court of Appeals for the Tenth Circuit.[9] While PCCU's case was pending, the Tenth Circuit

[9] In its first decision, the Tenth Circuit held, under existing law, that PCCU's first commercially marketable product was not finished cement. *United States* v. *Portland Cement Co. of Utah*, 293 F.2d 826 (10th Cir. 1961). In the second opinion involving the same years, the Tenth Circuit held that the depletion cutoff point (the first commercially marketable product) for PCCU was crushed limestone. 315 F.2d 169 (1963). In the third opinion involving the same years, the Tenth Circuit held that PCCU's mining ended with primary crushing, and that PCCU's gross income from mining must be determined at this point. 338 F.2d 798 (1964). In the fourth opinion involving the same years, the Tenth Circuit held, "on the record presented," that for percentage depletion purposes the proportionate profits method may be used to compute PCCU's constructive gross income from mining cement rock, and in doing so rejected PCCU's argument that a "substitute-materials" computation method

decided *United States* v. *Ideal Basic Industries, Inc.*, 404 F.2d 122 (10th Cir. 1968), in which it held that cement in bulk is an integrated miner-manufacturer's first marketable product under the proportionate profits method. Accordingly, in the fifth and final decision involving PCCU's taxable years 1954 through 1956, the court held that the government's application of the proportionate profits method with respect to PCCU was inconsistent with the proper application of the operative formula as set forth in *Ideal Basic*, and remanded the case to the trial court for disposition consistent with *Ideal Basic*. 412 F.2d 894 (1969).

PCCU followed the holding in *Ideal Basic* in the preparation of its income tax returns for fiscal years ended March 31, 1970 through March 31, 1972. Pursuant to *Ideal Basic*, PCCU took the position that finished cement in bulk was its first marketable product and that the bag premium and the bagging costs incurred in its bagging operation must therefore be excluded from the proportionate profits method computation. PCCU similarly excluded from the proportionate profits formula the costs that it incurred for the storage, distribution, and sale of its portland cement. (A. 17-31, 44-46, 50-52, 56-59, 63, 77).

On audit, the Commissioner of Internal Revenue determined deficiencies in PCCU's income tax liabilities for the fiscal years March 31, 1970 through March 31, 1972. The Commissioner's position is that:

(1) Finished cement, whether sold in bulk or in bags, constitutes PCCU's first marketable product, and

(2) The proportionate profits method employs a rigid mathematical formula which, when invoked, requires that the costs of all post-manufacturing functions—sales promotion, loading, storage, bagging and distribution—*always* be treated as nonmining costs and included in the "total costs" amount (the denominator of the fraction)

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more clearly reflected PCCU's gross income from mining. 378 F.2d 91 (1967).

used in the proportionate profits formula. (A. 12-16, 81-90, 91-99).

PCCU thereafter brought an action in the United States Tax Court for the redetermination of its deficiencies. The Tax Court upheld PCCU's computation of its constructive gross income from mining using the proportionate profits method. (Pet. App. 1a; T.C. Memorandum, 1977-137).[10]

On appeal by the government, the Tenth Circuit affirmed the holding of the Tax Court in a per curiam opinion, stating:

> As was held in our previous opinions, "bulk cement" is marketable as such, and under the Regulations it is the "first marketable product." The bagged cement is the next stage, and it is, as the Tax Court indicated, the second marketable product.
>
> The Government in its argument ignores the "first marketable" aspect of the Regulation, and would move to the second process—the bagging—because the cement in the bags is the same as in the bulk silos. It is obvious that both are "cement," but it is equally apparent that it is "first marketable" as bulk cement, not as bagged cement. (Pet. App. 12a, 14a-15a; 614 F.2d 724, 725 (10th Cir. 1979)).

The government then petitioned the Court for certiorari, which petition was granted on October 6, 1980. (A. 118).

## SUMMARY OF ARGUMENT

### I

A. The genesis of the present controversy is the percentage depletion allowance provided to miners. Section 611 of the Internal Revenue Code of 1954 provides a *reasonable* allowance for depletion, according to a miner's peculiar conditions. Under section 613(a) a miner must first determine its "gross income from mining"—the

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[10] Unofficially reported at CCH 36 TCM 578 and ¶ 77,136 P-H Memo TC.

market value of the crude mineral produced during the taxable year. Against this a statutory percentage, depending on the identity of the mineral product, is applied. The resulting amount (but not in excess of 50 percent of net income from mining) is the miner's percentage depletion allowance. Percentage depletion can be difficult to compute when there are no market values of the crude mineral product available because the miners in a particular mineral industry, such as the cement industry, manufacture their mineral product into a higher form. In this situation, a hypothetical market value must be ascertained; thus, the use of the proportionate profits method.

B. Regulation § 1.613-4(d)(4)(i) sets forth the proportionate profits method which operates by means of a formula comprised of a fraction, the numerator of which contains the costs of specified mining activities and the denominator of which in general contains all costs incurred with respect to activities occurring prior to the sale of the miner's first marketable product. The fraction is multiplied by the gross sales revenue of the first marketable product to produce an amount that is termed "gross income from mining"—the deemed market value of the miner's crude mineral product for purposes of computing percentage depletion. Reg. § 1.613-4(d)(4)(ii).

C. Mechanical application of this equation may be convenient, but it ignores the realities of the income produced by the various functions whose costs are utilized in the formula. It allows only considerations of relative costs to determine market value which, of course, is not the way the market really operates. More importantly, rigid application of the formula is inconsistent with the rationale of *United States* v. *Cannelton Sewer Pipe Co.*, 364 U.S. 76, 83, 86, 88-89 (1960), that an integrated miner-manufacturer is to be treated as if it constructively sold its crude mineral product to itself for manufacture into the first marketable product.

D. The market value for PCCU's mineral product at the cutoff point will be distorted if there is included in the application of the formula, as the government would do, the post-manufacturing activity of bagging, a customer service performed after the first marketable product is obtained, which does not enhance the value of the first marketable product and the costs of which are exceeded by the bagging charge. It is clearly established in the record (A. 105) that in this case the bag premium revenues realized by PCCU on the sale of bagged cement were less than the costs of performing the bagging operation. In other words, not only did the bagging operation, *per se*, not earn a profit but it in fact operated at a loss.

E. Simply stated, this case concerns whether for purposes of computing the percentage depletion allowance of an integrated miner-manufacturer, the proportionate profits method, which employs a mechanical formula, should be rigidly applied, ignoring the actual facts of PCCU's bagging operation, to determine the gross income from mining—the hypothetical market value of the crude mineral product; *or*, whether the fundamental purpose of the formula—to determine that market value of the miner's crude mineral product—should take precedence so that the formula may be flexibly applied when actual facts are inconsistent with rigid application.

F. The Tenth Circuit in this case and in *Ideal Basic Industries, Inc.* v. *United States*, 404 F.2d 122 (10th Cir. 1968) correctly sought to avoid the impermissible distortion that results from mechanical application of the formula by determining that the first marketable product of a cement miner-manufacturer is cement in bulk and not bagged cement. The desired minimization of distortion is achieved either by this means or by finding implicit in the proportonate profits formula the flexibility to permit excluding the costs and associated revenues of the bagging activity, when such costs exceed such associated revenues.

H. The government has recognized that the inclusion in the proportionate profits method of costs on which a profit is not earned has a distortive effect. In Reg. § 1.613-4(d)(1)(iii) the costs of transporting the mineral product to customers, "purchased transportation," are excluded from the formula because ordinarily the miner does not earn a profit on these costs. This provision recognizes that adjustments can be made to the proportionate profits method to cure distortions without undermining the basic premise of the method. The government also has recognized the distortive effects of the proportionate profits method in Technical Advice Release 992 (Sept. 30, 1968), which holds that the proportionate profits method is never appropriate for determining the cutoff point market value in the case of oil and gas production.

G. PCCU does not seek to overturn the proportionate profits method. Instead, PCCU contends that the proportionate profits method must be applied with flexibility since the purpose of the method is to ascertain by constructive means the market value for the miner's crude mineral product that would have resulted if the miner had sold the mineral product rather than processing it into a manufactured product. Modification of the government's rigid application of the method does not require the use of an alternative method; merely, as the Tenth Circuit Court of Appeals has held, that a rule of reason should prevail. The flexibility of application urged by PCCU is limited, both in scope and substance. It is only available in a relatively small number of situations when actual facts concerning the bagging operation justify flexible application. Moreover, this application does not produce any administrative inconvenience beyond that which is already accepted by the government.

II

In like manner, if selling and other marketing costs that clearly benefit PCCU's entire mining-manufacturing operation are treated as allocable only to manufacturing

activities in the proportionate profits computation, this will improperly distort the value of PCCU's cement rock. Virtually all the courts that have addressed this issue have recognized that Reg. §§ 1.613-4 and 1.613-5 clearly permit selling costs to be allocated to mining as well as manufacturing, and have so allocated selling costs included in the proportionate profits formula. This has been done both because such costs benefited the entire integrated operation and because it was properly assumed that an unintegrated miner typically incurs selling costs. *Arvonia-Buckingham Slate Co.* v. *United States*, 426 F.2d 484, 486 (4th Cir. 1970); *Southwestern Portland Cement Co.* v. *United States*, 435 F.2d 504, 508-509 (9th Cir. 1970); *United States* v. *California Portland Cement Co.*, 413 F.2d 161, 170-172 (9th Cir. 1969); *Whitehall Cement Manufacturing Co.* v. *United States*, 237 F. Supp. 838, 841 (E.D. Pa. 1965), *aff'd*, 369 F.2d 468 (3d Cir. 1966). A reasonable reading of the pertinent regulations likewise indicates that PCCU's marketing costs are properly allocable between its mining and manufacturing operations. Reg. §§ 1.613-4(d)(3)(iv), 1.613-5(c)(4).

## ARGUMENT

### I. THE INCLUSION OF THE BAGGING ACTIVITY IN THE PROPORTIONATE PROFITS FORMULA, WHEN BAGGING COSTS EXCEED THE BAG PREMIUM, PRODUCES AN IMPERMISSIBLY DISTORTED MARKET VALUE FOR THE CRUDE MINERAL PRODUCT.

#### A. The Purpose Of The Percentage Depletion Allowance Is To Compensate A Miner For The Exhaustion Of The Value Of Its Mineral, A Wasting Capital Asset.

The percentage depletion allowance is designed to compensate a taxpayer for the exhaustion of its mineral property as it is mined.[11] Under sections 611, 612, and

[11] The amount of the depletion allowance provided by section 611(a) must be reasonable, "according to the peculiar conditions of

613, the amount of the deduction is determined with reference to the taxpayer's "gross income from mining," which is the market value of the extracted mineral at the mining cutoff point.

In *United States* v. *Cannelton Sewer Pipe Co.*, 364 U.S. 76 (1960), the Court held that the proper value of a miner's mineral product, which is the depletion base for purposes of the percentage depletion computation, "[should be] the competitive market receipts, or its equivalent received from the sale of the crude products, or concentrates on an f.o.b. mine, mill or well basis." 364 U.S. at 83. In reaching this conclusion, the Court emphasized that the percentage depletion computation has no relationship to extraction and processing costs:

> [Percentage depletion] is not a subsidy to manufacturers or the high-cost mine operator. The value of [the miner's products] obtained by expensive manufacturing processes, bears little relation to the value of its minerals. The question in depletion is what allowance is necessary to permit tax-free recovery of the capital value of the minerals. 364 U.S. at 86.

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each case." In all cases, the reasonableness of such allowance must be determined pursuant to regulations prescribed by the Treasury. See Reg. § 1.611-0.

Since the specific circumstances in each case must be taken into account in the determination of a reasonable depletion deduction, it is implicit that the computation of the depletion deduction will give effect to such circumstances, and will take into account the pertinent realities evident in a particular case. Consequently, whenever circumstances require the use of a formula method to compute a taxpayer's allowable depletion deduction, the application of such method must give effect to actual facts, so that it will result in a reasonable depletion allowance in that particular case. Thus, notwithstanding the authority in section 611 permitting the Treasury to implement the depletion allowance by regulations, such regulations still must permit reference to the facts and circumstances in each case in determining a taxpayer's reasonable depletion allowance. See, *United States* v. *Cartwright*, 411 U.S. 546, 550, 553-557 (1973), in which the Court held that a method of valuing mutual fund shares for federal estate tax purposes was invalid because it failed to reflect reality.

Consistent with this, *Cannelton* provided that recovery of the costs incurred in the mining and manufacturing operations has "nothing to do with the value in the [percentage] depletion formulae." 364 U.S. at 88. Rather, "[d]epletion, as we read the legislative history, was designed not to recompense for costs of recovery but for exhaustion of the mineral assets alone." 364 U.S. at 88. Thus, *Cannelton* held that the Congress intended to treat taxpayers engaged in integrated mining and manufacturing operations as if they constructively sold their mined mineral to themselves for manufacturing into a first marketable product. 364 U.S. at 89.

In other words, the teaching of *Cannelton* is that in the case of an integrated miner-manufacturer the two phases of the overall business must be separated into independent operations, so that the mining function is deemed to make constructive sales of the mineral product to the manufacturing function.

### B. Literal Application Of The Proportionate Profits Method Produces A Distorted Value Of The Mineral At The Cutoff Point.

The proportionate profits method of determining the market value of the mineral at the cutoff point set forth in Reg. § 1.613-4(d), first appeared in 1940 in Reg. 103 (1939 Code), § 19.23(m)-1(f). During its 40-year existence, several courts have recognized the proportionate profits method as at least one reasonable means of determining a cutoff point market value in an appropriate case; i.e., when an integrated miner has no actual sales and is unable to refer to a representative market price to make such determination. E.g., *Arvonia-Buckingham Slate Co.* v. *United States*, 426 F.2d 484, (4th Cir. 1970); *United States* v. *Ideal Basic Industries, Inc.*, 404 F.2d 122, 125 (10th Cir. 1969); *Henderson Clay Products Co.* v. *United States*, 377 F.2d 349 (5th Cir. 1967).

The government's rigid application of the proportionate profits method, however, is at odds with the rationale of *Cannelton* because the proportionate profits method does

not treat the mining and manufacturing phases of an integrated miner as two separate businesses. Rather, rigidly applied, the proportionate profits method treats the entire mining-manufacturing operation as one business in the sense that profits derived from the sale of the first marketable product are arbitrarily allocated between the two functions. Pursuant to such allocation, neither business stands on its own and functions as an independent operation; nor is there any arm's-length market influence at work because each business must share its profits with the other.

Because the proportionate profits formula employs a mechanical cost allocation to determine the gross income from mining of the integrated miner-manufacturer—the market value of the mineral product at the cutoff point —it is apparent that the potential for distortion of that value increases with the addition of each post-mining process or function and the associated costs to the formula. In other words, the greater the number of non-mining processes, and accordingly the costs thereof included in the denominator of the formula, the greater the potential for unjustified variations in the market value attributed to the miner's mineral product at the cutoff point.

The distortive potential is particularly acute when there are included in applying the formula post-manufacturing functions, such as bagging, that do not produce incremental revenues sufficient to offset the costs attributable to such functions. This is because the proportionate profits formula assumes that such functions earn a proportionate amount of total revenue. When this happens, the reduction in the gross income from mining—the value of the mineral at the cutoff point—produced by the literal application of the proportionate profits method is distortive and unjustified.[12]

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[12] The only accounting authority cited by the government as purporting to support the proportionate profits method was written

Simply stated, this case presents the question whether, in applying the mechanical formula of the proportionate profits method to determine the hypothetical market value of the crude mineral product at the cutoff point, the application is to be a rigid one, ignoring actual facts, *or* whether there is to be sufficient flexibility in the application of the method to permit actual facts to be taken into account so that the purpose of the application—to determine the market value of the crude mineral product —can be achieved.

The Tenth Circuit in *Ideal Basic Industries, Inc.* v. *United States*, 404 F.2d 122 (10th Cir. 1968), recognized the necessity of doing something to eliminate the distortion which occurs when there is included in applying the formula the post-mining and manufacturing activity of bagging, the costs of which exceed the associated revenues. It sought to cure the distortion by determining that the first marketable product of an integrated miner-manufacturer of cement is cement in bulk and not also cement on which the additional activity of bagging has

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forty years ago, and when placed in proper context it is inapposite to the government's position. (G. Brf. p. 16). The cited authority neither describes the proportionate profits method nor discusses the application of such formula in any way. The subject of the discussion is income, not value; the allocation of profits is not mentioned. Moreover, the gist of the discussion is that all the costs of *a* particular business, not two businesses such as mining and manufacturing, must be treated equally for purposes of matching costs to revenue *to recover* such costs. Recouping all costs from gross revenue is quite different from the government's position that the market value of a mineral product at the cutoff point must be determined by allocating a proportionate amount of revenue, including profits, to each of the costs.

Even assuming *arguendo* that the proportionate profits method is based on generally accepted accounting principles, which it is not, the operative formula may not be rigidly applied when it does not clearly reflect PCCU's gross income from mining. *American Automobile Assn.* v. *United States*, 367 U.S. 687, 693 (1961); *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522, 538-539 (1979); see Reg. § 1.446-1(d)(3).

been performed. In other words, by this means the Tenth Circuit was simply recognizing that the proportionate profits formula must be applied by taking into account as few processes occurring after the cutoff point as is feasibly possible, if distortion in the determination of the value of the mineral product at that cutoff point is to be minimized.

The desired minimization of distortion is achieved by the means employed by the Tenth Circuit—treating cement in bulk as the first marketable product—or by finding implicit in the basic methodology of the proportionate profits formula the flexibility that can permit the exclusion from the formula of the costs and associated revenues of the bagging activity, the costs of which exceed the associated revenues.[13]

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[13] Neither the government's regulations concerning the depletion allowance, nor the government's application of the regulations is sacrosanct merely because of the delegation of authority to the Treasury in section 611. Several courts, although upholding parts of Reg. § 1.613-4 or its predecessors in general, have not accepted the government's application of the rules in these regulations. In *Barton Mines Corp.* v. *Commissioner*, 446 F.2d 981, 994 (1971), *rev'g in part*, 53 T.C. 241, 258 (1969), both the Second Circuit and the Tax Court refused to follow the government's restrictive "sudden death" rule that all processes following the first nonmining process must be treated as nonmining processes for purposes of computing percentage depletion. In *Ranchers Expl. and Dev. Corp.* v. *United States*, —— F.2d —— (10th Cir. 1980) (unofficially reported at CCH 80-2 USTC ¶ 9815 at p. 85,692; P-H 46 AFTR2d 80-6124 at p. 80-6129), the court used a "common sense" analysis in holding that two sophisticated processes—solvent extraction and electrowinning—were not refining, a nonmining process under Reg. § 1.613-4(g)(6)(iii), but mining processes "within the spirit" as well as "the letter of the law permitting depletion." In *Union Carbide Corp.*, 75 T.C. No. 16 (November 12, 1980) (unofficially reported at CCH Dec. 37,391 at p. 4405 and ¶ 75.16 P-H TC at p. 75-136), the court reached the same conclusions as both *Barton Mines* on the "sudden death" rule in Reg. § 1.613-4(g)(2) and *Rancher's Expl. and Dev.* on solvent extraction.

PCCU *does not* contest the validity of a proportionate profits technique for determining the market value of its mineral product—its constructive gross income from mining. PCCU's position is simply that because the proportionate profits method employs a mechanical formula to determine a market value, which formula relies entirely on costs for the allocation of revenue, it is susceptible to distortion of constructive gross income from mining if it takes into account nonmining processes or functions that occur beyond the point at which constructive gross income from mining can first be determined. Accordingly, it must not be literally and blindly applied. Rather, its application must be carefully restricted so that the potential for distortion through the introduction of additional nonmining operations, the prices charged for such operations, and the costs incurred in such operations does not undermine the overriding purpose of Reg. § 1.613-4. That is to say, the constructive gross income from mining determined under the proportionate profits method should represent as nearly as feasible the market value of the miner's crude mineral product.[14]

That market value will be distorted, however, if there are included in the application of the formula, as the government would do, the costs and revenues relating

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[14] PCCU's flexible application of the proportionate profits method is a refinement to the method, not an alternative method as contemplated in the procedure set forth at Reg. § 1.613-4(d)(1)(ii). The central premise of the proportionate profits method—that all operating costs earn a proportionate share of sales revenue—is still the operative force. Its application is essentially retained intact, since all direct and indirect mining and manufacturing costs, by far the majority of the costs, are utilized. Solely costs that are attributed to the discrete post-manufacturing function of bagging are excludable, and only when actual facts demonstrate that the function, per se, did not earn a profit.

Consistent with this, the government's own regulations set forth alternative methods that are based on entirely different theories. None of these theories utilizes operating costs as a basis of valuing the mineral product. Reg. §§ 1.613-4(d)(5)-(7).

to the post-manufacturing activity of bagging, a customer service which is subsequent to and does not enhance the value of the first marketable product, and does not otherwise produce a profit on its own. In other words, the proportionate profits method should be applied with a degree of flexibility in a case such as this, since the purpose of the method is to ascertain by constructive means the market value for the miner's crude mineral product that would have resulted if the miner had sold the mineral product rather than processing it into a manufactured product.

On the other hand, the government's position is that once invoked the proportionate profits formula must always be rigidly and literally applied, regardless of whether the result produced—the value of the taxpayer's mineral at the cutoff point—is a reasonable one in light of the actual facts.[15] This position exalts the form in which the proportionate profits method operates over the substantive value which the method seeks constructively to obtain.

### C. In The Cement Industry, Bagging Is Associated With A Clearly Identifiable Income Item—The Bag Premium.

When customers purchase portland cement from PCCU in bags, rather than in bulk, they pay an additional charge for a given quantity of cement. The excess of the price of bagged cement over the price for the same quantity of bulk cement is referred to as a "bag premium." The bag premium is uniformly paid by all

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[15] The government implies that the proportionate profits method likewise is based on sales data. (G. Brf. p. 2). That implication is misleading because the sales data is attributable to a product that is substantially different from the crude mineral product being valued. For this reason, the proportionate profits method should be readily susceptible to compensating adjustments to minimize the distortions in the "workback" mechanism of the proportionate profits formula to obtain a value for the pre-existing mineral products.

customers who buy bagged cement. Thus, sales of bagged cement have a specifically identifiable income item that can be segregated from the sales revenues attributable to bulk cement. This fact is clearly established on the Tax Court record. (A. 104-108).

A comparison of PCCU's total bagging costs with its total bag premium revenue during each of taxable years in issue establishes that such costs exceeded the total bag premium revenues by significant amounts:

| Fiscal year ended | Excess bagging costs |
|---|---|
| March 31, 1970 | $55,410.88 |
| March 31, 1971 | 66,667.45 |
| March 31, 1972 | 64,590.41 |

(A. 100-103).

The obvious result is that PCCU's bagging service, *per se*, did not produce a profit, but actually was operated at a loss for each of the taxable years involved.

Since the government takes the position that portland cement is the first marketable product in the manufacture of cement, there should be no dispute that bagging is a post-manufacturing activity with marketing objectives.[16] Bagging is also a discrete function that is performed on bulk cement after it leaves the manufacturing area of

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[16] Logically, bagging costs are essentially selling costs which, because they benefit PCCU's entire integrated operation, should be allocated between mining and manufacturing. The regulations appear to take a contrary position. Reg. § 1.613-4(d)(3)(iii). Since selling costs, including bagging costs, do not enhance the inherent value of either the cement rock or finished cement, the inclusion of such costs at all in a mechanical allocation formula is open to serious question. This is especially the case since percentage depletion is not intended to be related to costs or cost recovery. *United States* v. *Cannelton Sewer Pipe Co.*, 364 U.S. 76, 88 (1960). To the extent, however, that selling costs, including bagging costs, are included in the formula, they must be considered to benefit equally the mining and manufacturing phases of the operation and, accordingly, must be ratably allocated to both phases.

the cement plant. Moreover, bagging is a discretionary service that is only done in response to a specific request by a customer; it is a customer accommodation. Whether cement is bagged is dependent on a particular customer's order.

There is no storage of bagged cement since bagging occurs at the time that a customer places an order to purchase cement in bags. In this sense, the bagging operation is an incidental part of the overall operation of PCCU's cement plant. Consistent with this, bagged cement accounts for only a small part—6 to 8 percent—of PCCU's total cement sales.

Based on the undisputed evidence in the record that the costs of PCCU's bagging service exceeded the bag preminum revenues, it is clear that bagging costs did not produce a profit, and there is no logical reason why the application of the proportionate profits method should require the inclusion of bagging costs in the computation, with the effect that they are presumed to earn a profit. Inclusion of the bagging costs in the computation unjustifiably distorts the market value of the mineral product (kiln-feed) produced by the mining operation.

This distortion is particularly onerous in this case since the facts show that PCCU mines a unique type of cement rock which has a high value as a raw material for use in the manufacture of portland cement. PCCU's cement rock is valuable because it contains the major constituents needed to manufacture cement. This reduces both mining and manufacturing costs.

PCCU's mining operations are cost-efficient because PCCU is not required to duplicate its mining operations to obtain both calcium and silica, the two primary ingredients necessary to manufacture finished cement; a single mine produces both. Post-extraction mining processes also are simplified because there is less blending of purchased additives to obtain the desirable kiln-feed mixture.

**D. Rigid Application Of The Proportionate Profits Method Produces Anomalous Results.**

The present case—one in which the bagging service does not result in a profit—is a perfect example of the unjustified distortion in the market value of the mineral product that can result from a rigid application of the proportionate profits method. Under the government's mechanical interpretation of the formula, two equal units of identical kiln-feed—the mineral product at the cut-off point—manufactured into finished cement and sold on the same date in the same market area will have different values depending on whether the finished cement is sold in bulk or in bags. In other words, if kiln-feed is processed into finished cement that is sold both in bulk and in bags the kiln-feed in the bags will, when subjected to a mechanical application of the proportionate profits method, be determined to have a lower value per unit at the cutoff point than the value of kiln-feed sold in the form of bulk finished cement.

This unjustified distortion is also illustrated by the case of two integrated miner-manufacturers in the same market who have identical mineral deposits and mining and manufacturing operations, and who incur identical operating costs. The only distinction between the two businesses is that one sells most of its finished cement in bulk and the other sells most of its finished cement in bags and, as in PCCU's case, does not make a profit on the bagging operation. A mechanical application of the proportionate profits method will result in the identical cement rock at the cutoff point—kiln-feed—having a lower market value for the integrated miner that sells most of its cement in bags, than for the rival integrated miner that sells most of its finished cement in bulk.

Such discrimination in result makes no sense. The value of the mineral product is being altered because of an operation, which itself does not result in a profit, that follows both mining and manufacturing. In effect,

the method of disposition has an unjustified impact on the value of an integrated miner's mineral product although both the mineral product and the first marketable product are the same as the products of its competitor.

Rigid application of the proportionate profits method says the miner's cement rock at the cutoff point has one market value when it is sold to the bulk cement manufacturer and a lower market value when it is sold to the bag cement manufacturer. This is a patently unrealistic result. An unintegrated cement rock miner would not sell its mineral product for one price when the purchaser is a manufacturer of bulk cement and at a lower price when the purchaser is a manufacturer of bagged cement. Stated differently, the cement rock miner would not lower the price of its mineral product to the manufacturer of bagged cement just because the manufacture and sale of cement in bags is less profitable than the manufacture and sale of bulk cement.

### E. The Proportionate Profits Formula Should And Does Have Room For Recognizing Reality.

The regulations demonstrate that excluding nonprofitable costs from the proportionate profits formula does not abuse the fundamental premise of such formula. This is clearly seen in the treatment of "purchased transportation" in Reg. § 1.613-4(e)(2)(ii). Under these provisions, an adjustment is made in the application of the proportionate profits method so that no profit is attributed to the cost of purchased transportation for delivery to either the customer or temporary storage.[17] The cost of that transportation is excluded from the miner's gross sales figure of the first marketable product and from the

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[17] Apparently, similar treatment is allowed for sales taxes which are passed on to the customer. (A. 77). It is clear in the case of taxes, as in the case of purchased transportation, that the miner does not earn a profit on that cost.

denominator of the proportionate profits fraction because it is clear that the miner does not earn a profit on this transportation. This treatment is contrary in principle to the application of the proportionate profits method contended for by the government.

The provisions of Reg. § 1.613-4(e)(2)(ii), regarding the treatment of purchased transportation, establish that neither administrative convenience nor the central premise of the proportionate profits method are unduly jeopardized when actual facts are taken into account to make reasonable compensating adjustments to the application of such method.[18]

Another clear illustration of the government's recognition that the proportionate profits method distorts is the government's blanket refusal to apply such method to determine the constructive value of the oil and gas produced by an integrated producer. In Technical Information Release 992 (September 30, 1968)[19] the government stated that the proportionate profits method of computation is not appropriate in the case of producers of petroleum and natural gas. It said that use of the proportionate profits method is inappropriate in cases in which the costs paid to produce, sell and transport the first marketable product from oil and gas production are not substantial compared to the taxpayer's gross sales of such product, and that pertinent data indicated that the costs associated with oil and gas pro-

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[18] Making adjustments in the application of the proportionate profits method to reflect reality is consistent with the flexibility indicated in Reg. §§ 1.613-4(c) & (e) concerning the application of the representative market or field price method. In determining representative prices there is leeway in determining market size, Reg. § 1.613-4(c)(3); comparability of mineral products, Reg. § 1.613-4(c)(4); nonrepresentative sale transactions and sale price adjustments, Reg. § 1.613-4(e)(1) & (2). See *Bloomington Limestone Corp.* v. *United States*, 445 F.2d 1105 (7th Cir. 1971) and *Hugoton Prod. Co.* v. *United States*, 349 F.2d 418 (Ct. Cl. 1965).

[19] Unofficially published at CCH 687 SFTR ¶ 6929E, P-H ——.

duction only average about 17.5 percent of the gross sales receipts of the marketed product. See *Hugoton Production Co.* v. *United States*, 349 F.2d 418 (Ct. Cl. 1965).

**F. By Determining That Cement In Bulk Is The First Marketable Product And Accordingly Requiring That All Post-Manufacturing Functions Be Excluded From The Proportionate Profits Formula, The Court Of Appeals Sought To Achieve An Application Of The Proportionate Profits Method Which Avoids Distortion And Provides A Representative Value Of The Taxpayer's Mineral Product.**

The post-manufacturing operations of an integrated miner-manufacturer are services performed for the benefit of customers. As a consequence, including post-manufacturing costs and their related income in the proportionate profits formula distorts the imputed value of the mineral product.

The Tenth Circuit has consistently recognized the distortive effect of including nonprofit costs in the proportionate profits formula. In an opinion concerning PCCU's case for taxable years 1954 through 1956, *United States* v. *Portland Cement Co. of Utah*, 378 F.2d 91 (10th Cir. 1967), *cert. denied*, 389 U.S. 975 (1968), the court reasoned that, "[i]f inclusion of unproductive costs so distorts the equation that the application of the formula does not in fact clearly reflect the gross income from the property, they may be excluded." 378 F.2d at 94-95. Based on the record in that case, however, the court refused to exclude any post-manufacturing costs from the proportionate profits formula because it determined that PCCU had not made an adequate showing that specific costs were unproductive.

Subsequently, in *United States* v. *Ideal Basic Industries, Inc.*, 404 F.2d 122, 127 (10th Cir. 1968), both the majority and the dissenting opinions recognized that there is a distortion of the miner's depletion base when

the proportionate profits formula is applied without any reference to the income produced by the costs utilized.

In *Ideal Basic*, the court was concerned about the distortive effect of including post-manufacturing costs in the proportionate profits formula:

> [t]he basic principle concerned is to allow a deduction to compensate for the depleting resource and, therefore, the [proportionate profits] formula is oriented to the value of the resource at the time of its extraction rather than to the ultimate sale price of the manufactured product. 404 F.2d at 126.

Noting that the value sought by use of the proportionate profits formula is the real price at which kiln-feed would sell in a hypothetically free market place, the court concluded that:

> The intent [of the proportionate profits formula] is to establish this real market price as near the mine as possible, therefore, the liturgy of "first marketable product." * * * * The logic of this approach is, the closer to the mine that the mining costs, the cost of the bulk cement, and the free market price can be established, the smaller the possibility of the distortion of the depletion figure, and the fairer the result for the taxpayer and the government. 404 F.2d at 126-127.

To minimize the potential distortion, the Tenth Circuit determined that the first marketable product of a cement manufacturer is bulk cement. By this determination, the costs of subsequent operations, such as bagging, selling, transportation and terminal expenses, were excluded from the application of the proportionate profits method. These post-manufacturing costs thus could not result in distortions in the determination of the value of the kiln-feed —the mineral product at the cut-off point.

By concluding that bulk cement was the first marketable product of an integrated cement miner-manufacturer,

the court remedied the distortive effect of including post-manufacturing activities in the formula in a forthright and practical manner. The Tenth Circuit correctly found sufficient flexibility in the language of the regulation to allow application of the proportionate profits method so that the inherent distortions of the method were minimized.[20]

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[20] In general, pro rata allocation of any item is arbitrary because it assumes uniformity when reality rarely assumes a constant pattern. Although convenient in application, pro rata allocations are subject to the criticisms of inaccuracy and artificiality. Indeed, the Court criticized and rejected as unacceptable a pro rata allocation of income in another tax context because it was artificial and did not clearly reflect income. See *American Automobile Assn.* v. *United States*, 367 U.S. 687, 693 (1961).

The Courts have consistently recognized that the proportionate profits method is subject to distortion when nonprofit costs are improperly taken into account, even though under the specific facts of the situations involved, they did not find a basis for corrective action. *Southwestern Portland Cement Co.* v. *United States*, 435 F.2d 504, 508 (9th Cir. 1970); *General Portland Cement Co.* v. *United States*, 438 F. Supp. 27, 32 (N.D. Tex. 1977), *aff'd on this issue*, 628 F.2d 321 (5th Cir. 1980); *Whitehall Cement Manufacturing Co.* v. *United States*, 242 F. Supp. 327, 329 (E.D. Pa. 1965), *aff'd* 369 F.2d 468 (3d Cir. 1966).

The Court of Claims also has recognized the tendency of the costs and revenues associated with post-manufacturing functions to distort a proper application of the proportionate profits formula. In *Hugoton Production Co.* v. *United States*, 349 F.2d 418 (Ct. Cl. 1965), the court resorted to a modified representative market or field price method to determine the wellhead value of the taxpayer's unprocessed natural gas because, due to the lack of any meaningful relationship between the costs of producing natural gas and the costs of processing such gas prior to sale, the proportionate profits formula produced a gross income from the mineral property which was not a representative value in light of market realities.

*North Carolina Granite Corp.* v. *Commissioner*, 56 T.C. 1281 (1971), *acq. in result*, 1974-2 C.B. 3, provides a classic example of the potential distortive effect of a rigid application of the proportionate profits method. In that case the taxpayer operated a stone quarry in concert with two manufacturing operations—a curb stone division and an ornamental stone division. The orna-

### G. The Argument Advanced In *Whitehall Cement Manufacturing* And In *General Portland Cement* And Relied Upon By The Government That Some Of The Value Created By A Miner's Mining-Manufacturing Operation Is Properly Allocable To Bagging Is Erroneous.

In *Whitehall Cement Manufacturing Co.* v. *United States*, 369 F.2d 468 (3d Cir. 1966), the court recognized that the bag premium the taxpayer charged its customers was less than the costs of the bagging service. Notwithstanding such fact, the court adopted a literal application of the proportionate profits method. It accepted the trial judge's erroneous reasoning[21] that a pro rata share of the taxpayer's profits from the mining and manufacture of finished cement was allocable to the bagging service because the taxpayer realized a profit on the sale of bagged cement, albeit less than on the sale of bulk cement, and because:

> It seems reasonable to infer that the profits realized from the sale of packaged cement, and these were substantial, were attributable at least in part to packaging costs. 369 F.2d at 474.

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mental stone division was a inefficient operation, and its products were sold at a loss. The court found that every dollar of cost in the taxpayer's operations did not produce the same amount of profit, 56 T.C. at 1290, and then gave effect to that finding in its application of the proportionate profits formula. The court concluded that since the purpose of any method of computing gross income from mining is to arrive at a figure which approximates the result that would obtain if actual market prices were available for the taxpayer's mineral product, it was appropriate to modify the application of the proportionate profits method formula to exclude the costs and the income attributable to the ornamental stone division. 56 T.C. at 1291. The holding in *North Carolina Granite Corp.* demonstrates that a reasonable, comon sense application of the proportionate profits method based on actual facts is not only permissible under the regulations but also appropriate.

[21] 242 F.Supp. 326, 329 (E.D. Pa. 1965).

Subsequently, this rationale was also advanced by the Fifth Circuit in *General Portland*, 628 F.2d 321 (1980).

The rationale in *Whitehall Cement* is erroneous for several reasons. Principally, the rationale ignores the reason for which the proportionate profits method is applied, and it is contradicted by the clear results of implementing that rationale. The purpose for which the proportionate profits method is applied is to determine the market value of the taxpayer's mineral product at the cutoff point. It is not merely to engage in some theoretical profit allocation. As previously demonstrated, the inclusion of demonstrably nonprofit post-manufacturing costs, such as the costs of the bagging operation in the present case, in the application of the proportionate profits method, will produce an absurd result. (See pp. 23-24, *supra*). The value at the cutoff point of the taxpayer's cement rock that is ultimately sold as finished cement in bags will be lower than the value at the cutoff point of the identical cement rock which is ultimately sold as finished cement in bulk.

There is no disputing that the taxpayers in *Whitehall Cement* and *General Portland Cement* realized profits from the sale of bagged cement, and realized profits from the sale of cement in bulk. To that extent, the statements in these cases that the taxpayers' profits are partly attributable to the sale of bagged cement are correct. It is fallacious reasoning, however, to proceed from that factual conclusion to a legal conclusion which results in different values for the taxpayer's cement rock at the cutoff point, depending on whether the rock is processed into cement that is sold in bulk or into cement that is sold in bags. That is precisely the result of relying on the *Whitehall* rationale to justify the inclusion of nonprofit, post-manufacturing costs, such as those of a bagging operation, in the application of the proportionate profits method. Moreover, it bears emphasis that the purpose of the proportionate profits formula is not

to ensure the recovery of bagging costs, but to determine a representative value of PCCU's cement rock at the cutoff point. This is the teaching of *Cannelton*. 364 U.S. at 88. (See pp. 14-15, *supra*).

Although the bagging costs in these cases did not create a loss on cement sold in bags, the bagging costs were not entirely recovered from the bag premium charged for the bagging service. Viewing the bagging service as a discrete function from mining and manufacturing, the bagging operation, *per se*, was not profitable. In light of the distortive effect of such bagging costs on the proportionate profits method, this finding alone is an adequate basis for excluding them from such formula.

The speculation in *Whitehall Cement* [22] that the bagging service may engender goodwill as a customer accommodation and, thus, presumably generate additional income from the sale of finished cement is also not a persuasive argument. Every service that a business performs to satisfy a customer may engender goodwill. However, goodwill is not income, much less profit. It is an intangible attribute, the value of which is uncertain at best in this context. In fact, there is no certainty that the bagging service even creates goodwill. It is a traditional service that is expected in the cement industry. Virtually every cement plant offers such service. The bagging operation is an incidental activity to the general objective of producing portland cement.

The government does not seek to include purchased transportation costs in the proportionate profits method formula based on intangible goodwill benefits. Reg. § 1.613-4(e)(2). However, such service also presumably creates goodwill by relieving the customer from the burden of having to arrange for such transportation and, perhaps, by providing such transportation at a lower cost due to volume usage. The significant point is that

[22] 242 F.Supp. 326, 329 (E.D. Pa. 1965).

although the bagging function, similarly to purchased transportation, may increase the amount of sales of finished cement, neither service, following the actual mining and manufacturing operations, enhances the inherent value of finished cement or earns a profit on its own.

In short, the considerations of whether or not the taxpayer makes a profit on the bagging of cement or whether the sale of bagged cement at a premium that is less than the costs of bagging creates goodwill or is an accommodation to the consumers relate to fundamentally different questions than the one addressed by the proportionate profits method. The question the proportionate profits method seeks to answer, and the purpose for which it is being applied, is to determine the value of the taxpayer's mineral product at the cutoff point—the statutory point at which an unintegrated cement rock miner would sell its mineral product to an unrelated manufacturer of finished cement.

## II. PCCU'S SELLING AND OTHER MARKETING COSTS BENEFIT THE ENTIRE MINING AND MANUFACTURING OPERATION AND ARE PROPERLY ALLOCATED BETWEEN ITS MINING AND ITS MANUFACTURING OPERATIONS BASED ON THE PROPORTIONATE RELATIONSHIP OF DIRECT COSTS.

### A. Marketing Costs Are Indirect Costs That Are Inextricably Linked To Both Mining And Manufacturing.

PCCU incurs selling and other marketing expenses.[23] These relate to expenses consisting primarily of the compensation, together with entertainment and automobile expenses, that it pays its salesman, who is responsible for selling finished cement to industrial and commercial users, and to storing and shipping expenses. A minor amount of selling expenses is attributable to local advertising and public relations.

During each of the years in issue PCCU also paid substantial dues to the Portland Cement Association.[24] A substantial portion of these dues were used by the Portland Cement Association to promote the use of portland cement. The parties have agreed that the Portland Cement Association dues constitute indirect costs which should be apportioned between mining and nonmining

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[23] The amounts involved are as follows:

| | Selling Expenses | Storing and Shipping Expenses |
|---|---|---|
| March 31, 1970 | $47,178.47 | $ 95,594.28 |
| March 31, 1971 | 47,345.19 | 113,538.53 |
| March 31, 1972 | 54,003.63 | 118,953.56 |

(A. 39-40, 106-108).

[24] The amounts involved were as follows:

| | |
|---|---|
| March 31, 1970 | $35,268.85 |
| March 31, 1971 | 20,032.84 |
| March 31, 1972 | 18,186.85 |

(A. 37-38).

based on the proportion of the direct costs of mining to the direct costs of nonmining. (A. 38).

Any product whether mined or manufactured must be marketed to make a profit. Without the sales of the finished cement, PCCU would be unable to operate either its mining or its manufacturing functions. Presumably, some sales and promotion activities are conducted in most businesses. Consequently, marketing costs are in the nature of indirect costs which benefit the entire integrated operation, both the mining and the manufacturing phases.

**B. Under The Circumstances Involved, The Government May Not Narrowly Apply Reg. § 1.613-4(d)(3)(iv) So As To Compel PCCU To Provide Direct Proof That Unintegrated Miners In The Cement Industry Typically Incur Selling Costs.**

Regulation § 1.613-4(d)(3)(iv) provides that in computing gross income from mining under the proportionate profits method, selling expenses and trade association dues may be treated as indirect costs attributable to mining to the extent allowable under the principles set forth in Reg. § 1.613-5(c)(5). Indirect costs may be allocated between mining and manufacturing based on the proportion of direct mining costs to total direct nonmining costs. Reg. § 1.613-4(d)(4)(iii).[25]

Regulation § 1.613-5(c)(4) pertains to the treatment of selling expenses for purposes of computing a miner's taxable income from the mineral property:

> A reasonable portion of the expenses of selling a refined, manufactured, or fabricated product shall be subtracted from gross income from the property. Such reasonable portion shall be equivalent to the typical selling expenses which are incurred by unintegrated miners or producers in the same mineral industry so as to maintain equality in the tax treat-

[25] Under the court of appeals' holding that cement in bulk is the first makretable product, these costs are excluded from the proportionate profits formula and, thus, the question of allocation is not reached; in this case allocation produces the same result.

> ment of unintegrated miners or producers in comparison with integrated miner-manufacturers or producer-manufacturers. If unintegrated miners or producers in the same mineral industry do not typically incur any selling expenses, then no portion of the expenses of selling a refined, manufactured, or fabricated product shall be subtracted from gross income from the property when determining the taxpayer's taxable income from the property. Reg. § 1.613-5(c) (4) (ii).
>
> * * * *
>
> "[S]elling expenses" [in this regard] includes [such items as] sales management salaries, rent of sales offices, sales clerical expenses, salesmen's salaries, sales commissions and bonuses, advertising expenses, sales traveling expenses, and similar expenses, together with an allocable share of the costs of supporting services. § 1.613-5(c) (4) (iv).

Although in the case of the cement industry there is no intrinsic difference between marketing expenses in the form of selling expenses and marketing expenses in the form of loading, storage and distribution expenses, Reg. § 1.613-4(d) (3) appears to differentiate between these two categories of marketing expenses. The resulting difference in treatment is wholly without justification.[26]

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[26] Although Reg. § 1.613-4(d) (3) (iii) provides that the costs of bulk loading of, and operation of warehouses or distribution terminals for, manufactured products are nonmining costs for purposes of the proportionate profits method, it is clear that loading, storage and distribution costs incurred during the marketing phase equally benefit the mining and manufacturing phases of PCCU's entire integrated operation. Moreover, the government recognizes that loading, storage and distribution are not significant "processes" since purchased transportation to or from "incidental storage" may be excluded from the proportionate profits formula. Reg. § 1.613-4(e) (2) (iii) (b). Accordingly, to the extent Reg. § 1.613-4(d) (3) (iii) is considered applicable with respect to the cement industry, it is invalid. Since the storage and distribution expenses in question benefit PCCU's entire operation, they must be allocated for purposes of the proportionate profits method to both phases of the entire operation in the same manner as is provided in Reg. § 1.613-4(d) (3) (iv) for selling expenses.

The government's position with respect to PCCU's selling expenses and its other marketing expenses is a predictable extension of the rigid position that it has taken with respect to bagging costs. On brief, the government contends that PCCU is not entitled to allocate its selling expenses between its mining and manufacturing operations because it made no such showing that unintegrated miners in the cement industry would incur such selling expenses. (G. Brf. p. 25). The government concedes that several courts have taken a contrary position in this regard, but seeks to create the impression of being consistent with such cases by arguing that they were decided under earlier regulations that did not require a taxpayer to prove that unintegrated miners typically incur selling costs. (G. Brf. pp. 25-26).

The government's narrow reading of the provisions in the regulations concerning the treatment of selling expenses produces a harsh result which is necessary and unjustified.

As previously indicated, the cement industry is a fully integrated industry; it has no unintegrated miners. This is because the mineral product—cement rock—has no market of its own.[27] For this reason PCCU cannot directly prove that unintegrated miners of cement rock, who presumably would process such material into kiln-feed for use in the manufacture of portland cement, would typically incur selling expenses. By the same token, however, the allocation of selling expenses between mining and manufacturing results in equality of treatment among all cement rock miners since they all have integrated operations. Thus, the purpose of Reg. § 1.613-5 (c) (4) (ii) is fulfilled.

If there were unintegrated miners in the cement industry they would incur sales expenses to market their

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[27] *United States* v. *Portland Cement Co. of Utah*, 293 F.2d 826, 828 (10th Cir. 1961).

product to industrial cement manufacturers. Similarly, they would incur loading, storage and distribution expenses. Whether or not there *actually* are unintegrated cement miners, the *Cannelton* rationale presumes that there are. It is obvious that such a hypothetical, unintegrated cement rock miner would incur the same type of selling, storage, loading and distribution expenses as are incurred by PCCU.

Moreover, the government's position with respect to PCCU's local selling and marketing expenses is inconsistent with its treatment of Portland Cement Association dues. Recognition of this is implied in Reg. § 1.613-4(d)(3)(iv), which treats trade association dues and selling expenses essentially the same. The benefits that PCCU derives from the promotional activities are indistinguishable from the benefits derived from the sales activity of PCCU's salesman and its local advertising and promotional activities.

The cases that have considered the proper treatment of selling costs under the proportionate profits method formula have held that such selling costs are indirect costs which benefit the entire mining-manufacturing operation, and that such costs may be allocated between mining and manufacturing based on the direct costs attributable to such operations. In *Whitehall Cement Manufacturing Co.* v. *United States*, 237 F. Supp. 838 (E.D. Pa. 1965), *aff'd*, 369 F.2d 468 (3d Cir. 1966), the trial court specifically recognized that the government did not contend that the taxpayer's selling expenses were unusual in the cement industry or that such expenses would not have been incurred by an unintegrated miner. The court also noted that general administrative expenses benefited the entire mining-manufacturing operation and should be allocated between the two operations in proportion to the direct costs. Thus, there was no apparent reason why the two types of expenses—selling expenses and general administrative expenses—

should be accorded different treatment. 237 F. Supp. at 841.

The Ninth Circuit has also considered the proper treatment of selling expenses in the proportionate profits formula when applied to the cement industry. On two separate occasions, the court held that the taxpayer was entitled to allocate selling expenses between mining and manufacturing based on the direct costs incurred in each such operation. *Southwestern Portland Cement Co.* v. *United States*, 435 F.2d 504, 508-509 (9th Cir. 1970); *United States* v. *California Portland Cement Co.*, 413 F.2d 161, 170-172 (9th Cir. 1969).

What the government seeks with its narrow reading of Reg. § 1-613-5(c)(4) is to reverse the traditional presumption that miners normally incur selling expenses. Such narrow construction, however, must fail.

In *California Portland Cement* the Ninth Circuit properly assumed that mining businesses normally incur selling expenses, and it cited substantial authority, including *United States* v. *Cannelton Sewer Pipe Co.*, 364 U.S. 76 (1960), in support of this assumption. Concluding its analysis, the court commented that if an expense is incurred for the benefit of the entire operation, it can properly be allocated between mining and manufacturing:

> Otherwise, the nonintegrated miner would receive a tax advantage not intended by Congress. 413 F.2d at 172.

Asked to reconsider its position on the allocation of selling costs a year later, the Ninth Circuit again reached the same result in *Southwestern Portland Cement Co.*, 435 F.2d at 508-509.

Similarly, in *Arvonia-Buckingham Slate Co.* v. *United States*, 426 F.2d 484 (4th Cir. 1970), the court reasoned that the costs of advertising and sales are not directly identifiable with either a particular mining process or

a particular nonmining process. It concluded that such costs should be apportioned in accordance with the direct costs that are associated with the mining and manufacturing phases. Beyond this, the court held that the lower court's determination that all advertising and selling expense should be allocated to the nonmining phase was clearly erroneous in both fact and law. 426 F.2d at 486-487.

In summary, selling expenses and other marketing expenses, such as loading, storage and distribution, are in the nature of indirect costs which benefit the entire integrated mining and manufacturing operation. Such expenses are permissible mining costs, and should be allocated between mining and manufacturing based on the direct costs incurred in each such function. To reach this result requires only a reasonable reading of the regulations. It is not necessary to declare either Reg. § 1.613-4(d) (3) (iv) and Reg. § 1.613-5(c) (4) invalid.

## CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted,

December 23, 1980.

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# APPENDIX

## APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

### SEC. 611. ALLOWANCE OF DEDUCTION FOR DEPLETION.

(a) GENERAL RULE.—In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by Secretary. For purposes of this part, the term "mines" includes deposits of waste or residue, the extraction of ores or minerals from which is treated as mining under section 613(c). In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this section for subsequent taxable years shall be based on such revised estimate.

* * * *

### SEC. 613. PERCENTAGE DEPLETION.

(a) GENERAL RULE.—In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). For purposes of the preceding

sentence, the allowable deductions taken into account with respect to expenses of mining in computing the taxable income from the property shall be decreased by an amount equal to so much of any gain which (1) is treated under section 1245 (relating to gain from disposition of certain depreciable property) as ordinary income, and (2) is properly allocable to the property. In no case shall the allowance for depletion under section 611 be less than it would be if computed without reference to this section.

* * * *

(c) DEFINITION OF GROSS INCOME FROM PROPERTY.—For purposes of this section.

(1) GROSS INCOME FROM THE PROPERTY.—The term "gross income from the property" means, in the case of a property other than an oil or gas well and other than a geothermal deposit, the gross income from mining.

(2) MINING.—The term "mining" includes not merely the extraction of the ores or minerals from the ground but also the treatment processes considered as mining described in paragraph (4) (and the treatment processes necessary or incidental thereto), and so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to the plants or mills in which such treatment processes are applied thereto as is not in excess of 50 miles unless the Secretary finds that the physical and other requirements are such that the ore or mineral must be transported a greater distance to such plants or mills.

* * * *

(4) TREATMENT PROCESSES CONSIDERED AS MINING.—The following treatment processes where applied by the mine owner or operator shall be considered as mining to the extent they are applied to the ore or mineral in respect of which he is entitled to a deduction for depletion under section 611:

* * * *

(F) in the case of calcium carbonates and other minerals when used in making cement—all processes (other than preheating of the kiln feed) applied prior to the introduction of the kiln feed into the kiln, but not including any subsequent process;

* * * *

Treasury Regulations on Income Tax (1954 Code):

* * * *

§ 1.611-0. Regulatory authority.—Sections 1.611-1 through 1.614-8, inclusive, are prescribed under the authority granted the Secretary or his delegate by section 611(a) of the Code to prescribe regulations under which a reasonable allowance for depletion and depreciation of improvements shall be allowed, according to the peculiar conditions in each case, in the case of mines, oil and gas wells, other natural deposits and timber.

* * * *

§ 1.611-1. Allowance of deduction for depletion.—(a) *Depletion of mines, oil and gas wells, other natural deposits, and timber*—(1) *In general.* Section 611 provides that there shall be allowed as a deduction in computing taxable income in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion. In the case of standing timber, the depletion allow-

ance shall be computed solely upon the adjusted basis of the property. In the case of other exhaustible natural resources the allowance for depletion shall be computed upon either the adjusted depletion basis of the property (see section 612, relating to cost depletion) or upon a percentage of gross income from the property (see section 613, relating to percentage depletion), whichever results in the greater allowance for depletion for any taxable year. In no case will depletion based upon discovery value be allowed.

* * * *

§ 1.613-4. Gross income from the property in the case of minerals other than oil and gas.—(a) *In general.* * * *

* * * The term "gross income from the property," as used in section 613(c)(1), means, in the case of a mineral property other than an oil or gas property, gross income from mining. "Gross income from mining" is that amount of income which is attributable to the extraction of the ores or minerals from the ground and the application of mining processes, including mining transportation. * * *

* * * Processes, including packaging and transportation, which do not qualify as mining will be referred to as "nonmining processes." Also for the purpose of this section, transportation which qualifies as "mining" will be referred to as "mining transportation" and transportation which does not qualify as "mining" will be referred to as "nonmining transportation."

* * * *

(b) *Sales prior to the application of nonmining processes including nonmining transportation.* (1) Subject to the adjustments required by paragraph

(e)(1) of this section, gross income from mining means (except as provided in subparagraph (2) of this paragraph) the actual amount for which the ore or mineral is sold if the taxpayer sells the ore or mineral—

(i) As it emerges from the mine, prior to the application of any process other than a mining process or any transportation, or

(ii) After application of only mining processes, including mining transportation, and before any nonmining transportation.

* * * *

(c) *Cases where a representative market or field price for the taxpayer's ore or mineral can be ascertained*—(1) *General rule.* If the taxpayer processes the ore or mineral before sale by the application of nonmining processes (including nonmining transportation), or uses it in his operations, gross income from mining shall be computed by use of the representative market or field price of an ore or mineral of like kind and grade as the taxpayer's ore or mineral after the application of the mining processes actually applied (if any), including mining transportation (if any), and before any nonmining transportation, subject to any adjustments required by paragraph (e)(1) of this section. See paragraph (e)(2)(i) of this section for certain other situations in which this paragraph shall apply. The objective in computing gross income from mining by the representative market or field price method is to ascertain, on the basis of an analysis of actual competitive sales by the taxpayer or others, the dollar figure or amount which most nearly represents the approximate price at which the taxpayer, in light of market conditions, could have sold his ores or minerals if, prior to the application of nonmining

processes, the taxpayer had sold the quantities and types of ores and minerals to which he applied non-mining processes. If it is possible to determine a market or field price under the provisions of this paragraph, and if that price is determined to be representative, the taxpayer's gross income from mining shall be determined on the basis of that price and not under the provisions of paragraph (d) of this section. The taxpayer's own actual sales prices for ores or minerals of like kind and grade shall be taken into account when establishing market or field prices, provided that those sales are determined to be representative.

* * * *

(d) *Cases where a representative market or field price cannot be ascertained*—(1) *General rule.* (i) If it is impossible to determine a representative market or field price as described in paragraph (c) of this section then, except as provided in subdivision (ii) of this subparagraph, gross income from mining shall be computed by use of the proportionate profits method as set forth in subparagraph (4) of this paragraph. A method of computing gross income from mining under the provisions of this paragraph shall not be deemed to be a method of accounting for purposes of paragraph (e) of § 1.446-1.

(ii) (*a*) The Office of the Assistant Commissioner (Technical) may determine that a method of computation is more appropriate than the proportionate profits method or the method being used by the taxpayer. The taxpayer may request such a determination (see (*d*) of this subdivision (ii)). If the taxpayer is using a method of computation which has been determined by the Office of Assistant Commissioner (Technical) to be more appropriate than the proportionate profits method, such method

shall continue to be used until it is determined by the Office of Assistant Commissioner (Technical) that either the proportionate profits method or another method is more appropriate.

(*b*) The proportionate profits method is more appropriate than the method being used under (*a*) if, under the particular facts and circumstances, the method being used under (*a*) consistently fails to clearly reflect gross income from mining and the proportionate profits method more clearly reflects gross income from mining for the taxable year.

(*c*) An alternative method (a method other than the method being used under (*a*) (if any) and the proportionate profits method) is more appropriate than the method being used under (*a*) (if any) and the proportionate profits method if, under the particular facts and circumstances, the latter methods consistently fail to clearly reflect gross income from mining, and the alternative method being considered more clearly reflects gross income from mining on a consistent basis than the method being used under (*a*) (if any) and the proportionate profits method. When determining whether a method of computation clearly reflects gross income from mining, it is relevant to compare the gross income from mining produced by such method with the gross income from mining, on an equivalent amount of production, which results from the computation methods used by competitors. When determining the acceptability of proposed alternative methods, primary consideration will be given to computation methods based upon representative charges for ores, minerals, products, or services. See paragraph (c) of this section for principles determining the representative character of a charge.

(*d*) Application for permission to compute gross income from mining by use of an alternative method shall be made by submitting a request to the Commissioner of Internal Revenue, Attention: Assistant Commissioner (Technical), Washington, D.C. 20224.

(*e*) Among the alternative methods of computation to which consideration will be given, provided that the requirements of this subdivision (ii) are met, are the methods listed in subparagraphs (5), (6), and (7) of this paragraph. The order in which these methods are listed is not significant, and the listing of these methods does not preclude a request to make use of a method which is not listed.

(iii) Approval and continued use of any method of computation under this paragraph depends upon all the facts and circumstances in each case, and shall be subject to such terms and conditions as may be necessary in the opinion of the Commissioner to reflect clearly the gross income from mining. Accordingly, the use of such a method for any taxable year shall be subject to review and change.

(2) *Costs to be used in computing gross income from mining by use of methods based on the taxpayer's costs.* In determining the taxpayer's gross income from mining by use of methods based on the taxpayer's costs, only costs actually paid or incurred shall be taken into consideration. In general, if the taxpayer has consistently employed a reasonable method of determining the costs of the various individual phases of his mining and nonmining processes (such as extraction, loading for shipment, calcining, packaging, etc.), such method shall not be disturbed. The amount of any particular item to be taken into account shall, for taxable years beginning after No-

vember 30, 1968, be the amount used in determining the taxpayer's income for tax purposes. For example, the depreciation lives, methods, and records used for tax purposes, if different from those used for book purposes, shall be the basis for determining the amount of depreciation to be used. However, a taxpayer may continue to use a reasonable method for determining those costs on the basis of the amounts computed for cost control or similar financial or accounting books and records if that method has been used consistently and is applied to the determination of all those costs.

(3) *Treatment of particular items in computing gross income from the mining by use of methods based on the taxpayer's costs.* (i) Except as specifically provided elsewhere in this section, when determining gross income from mining by use of methods based on the taxpayer's costs, the costs attributable to mining transportation shall be treated as mining costs, and the costs attributable to nonmining transportation shall be treated as nonmining costs. Accordingly, except as specifically provided elsewhere in this section, all profits attributable to mining transportation shall be treated as mining profits, and all profits attributable to nonmining transportation shall be treated as nonmining profits. For this purpose, mining transportation means so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to plants or mills in which other mining processes are applied thereto as is not in excess of 50 miles or, if the taxpayer files an application pursuant to paragraph (h) of this section and the Commissioner finds that both the physical and other requirements are such that the ores or minerals must be transported a greater distance to such plants or mills, the transportation over

the greater distance. Further, for this purpose, nonmining transportation includes the transportation (whether or not by common carrier) of ores, minerals, or the products produced therefrom, from the point of extraction from the ground to nonmining facilities, or from a mining facility to a nonmining facility, or from one nonmining facility to another, or from a nonmining facility to the customers who purchase the taxpayer's first marketable product or group of products. See paragraph (e)(2) of this section for provisions relating to purchased transportation to the customer and paragraph (g)(3) of this section for provisions relating to transportation the primary purpose of which is marketing or distribution. In the absence of other methods which clearly reflect the costs of the various phases of transportation, the cost attributable to nonmining transportation shall be an amount which is in the same ratio to the costs incurred for the total transportation as the distance of the nonmining transportation is to the distance of the total transportation. As an example, where the plants or mills in which mining processes are applied to ores or minerals are in excess of 50 miles from the point of extraction from the ground (or in excess of a greater distance approved by the Commissioner), the costs incurred for transportation to those plants or mills in excess of 50 miles (or of that greater distance) shall be treated as nonmining costs in determining gross income from mining. Accordingly, all profits attributable to that excess transportation are treated as nonmining profits. However, except in the case of transportation performed in conveyances owned or leased by the taxpayer, the preceding sentence shall apply only to taxable years beginning after November 30, 1968.

(ii) In determining gross income from mining by use of methods based on the taxpayer's costs, a process shall not be considered as a mining process to the extent it is applied to ores, minerals, or other materials with respect to which the taxpayer is not entitled to a deduction for depletion under section 611. The costs of such nondepletable ores, minerals, or materials; the costs of the processes (including blending, size reduction, etc.) applied thereto; and the transportation costs thereof, if any, shall be considered as nonmining costs in determining gross income from mining. If a mining process is applied to an admixture of depletable and nondepletable material, the cost of the process and the cost of transportation, if any, attributable to the nondepletable material shall be considered as nonmining costs in determining gross income from mining. Accordingly, all profits attributable thereto are treated as nonmining profits. In the absence of other methods which clearly reflect the cost attributable to the processing and transportation, if any, of the nondepletable admixed material, that cost shall be deemed to be that proportion of the costs which the tonnage of nondepletable material bears to the total tonnage of both depletable and nondepletable material.

(iii) In determining gross income from mining by use of methods based on the taxpayer's costs—

(*a*) The costs attributable to containers, bags, packages, pallets, and similar items as well as the costs of materials and labor attributable to bagging, packaging, palletizing, or similar operations shall be considered as nonmining costs.

(*b*) The costs attributable to the bulk loading of manufactured products shall be considered as nonmining costs.

(*c*) The costs attributable to the operation of warehouses or distribution terminals for manufactured products shall be considered as nonmining costs.

Accordingly, all profits attributable thereto are treated as nonmining profits.

(iv) In computing gross income from mining by the use of methods based on the taxpayer's costs, the principles set forth in paragraph (c) of § 1.613-5 shall apply when determining whether selling expenses and trade association dues are to be treated, in whole or in part, as mining costs or as nonmining costs. To the extent that selling expenses and trade association dues are treated as nonmining costs, all profits attributable thereto are treated as nonmining profits.

(v) See paragraph (e) (1) of this section for provisions excluding certain allowances from the taxpayer's gross sales and costs of his first marketable product or group of products.

(4) *Proportionate profits method.* (i) The objective of the "proportionate profits method" of computation is to ascertain gross income from mining by applying the principle that each dollar of the total cost paid or incurred to produce, sell, and transport the first marketable product or group of products (as defined in subdivision (iv) of this subparagraph) earns the same percentage of profit. Accordingly, in the proportionate profits method no ranking of costs is permissible which results in excluding or minimizing the effect of any costs incurred to produce, sell, and transport the first marketable product or group of products. For purposes of this subparagraph, members of a controlled group shall be treated as divisions of a single tax-

payer. See paragraph (j) of this section for the definitions of the terms "controlled" and "group."

(ii) The proportionate profits method of computation is applied by multiplying the taxpayer's gross sales (actual or constructive) of his first marketable product or group of products (after making the adjustments required by paragraph (e) of this section) by a fraction whose numerator is the sum of all the costs allocable to those mining processes which are applied to produce, sell, and transport the first marketable product or group of products, and whose denominator is the total of all the mining and nonmining costs paid or incurred to produce, sell, and transport the first marketable product or group of products (after making the adjustments required by this paragraph and paragraph (e) of this section). The method as described herein is merely a restatement of the method formerly set forth in the second sentence of Regulations 118, § 39.23(m)-1(e)(3) (1939 Code). The proportionate profits method of computation may be illustrated by the following equation:

$$\frac{\text{Mining Costs}}{\text{Total Costs}} \times \text{Gross Sales} = \text{Gross Income from Mining}$$

(iii) Those costs which are paid or incurred by the taxpayer to produce, sell, and transport the first marketable product or group of products, and which are not directly identifiable with either a particular mining process or a particular nonmining process shall, in the absence of a specific provision of this section providing an apportionment method, be apportioned to mining and to nonmining by use of a method which is reasonable under the circumstances. One method which may be reasonable in a particular case is an allocation based on

the proportion that the direct costs of mining processes and the direct costs of nonmining processes bear to each other. For example, the salary of a corporate officer engaged in overseeing all of the taxpayer's processes is an expense which may reasonably be apportioned on the basis of the ratio between the direct costs of mining and nonmining processes. On the other hand, an expense such as workmen's compensation premiums would normally be apportioned on the basis of direct labor costs. For the rule relating to selling expenses, see paragraph (c) (4) of § 1.613-5.

(iv) As used in this section, the term "first marketable product or group of products" means the product (or group of essentially the same products) produced by the taxpayer as a result of the application of nonmining processes, in the form or condition in which such product or products are first marketed in significant quantities by the taxpayers or by others in the taxpayer's marketing area. For this purpose, bulk and packaged products are considered to be essentially the same product. Sales between members of a controlled group (as defined in paragraph (j) of this section) shall not be considered in making a determination under this subdivision. The first marketable product or group of products does not include any product which results from additional manufacturing or other nonmining processes applied to the product or products first marketed in significant quantities by the taxpayer or others in the taxpayer's marketing area. For example, if a cement manufacturer sells his own finished cement in bulk and bags and also sells concrete blocks or dry ready-mix aggregates containing additives, the finished cement, in bulk and bags, constitutes the first marketable product or group of products produced by him. Similarly, if an inte-

grated iron ore and steel producer sells both pig iron in various sizes and rolled sheet iron or shapes, his first marketable product is the pig iron in its various sizes. Further if an integrated clay and brick producer sells both unglazed bricks and tiles of various shapes and sizes and additionally manufactured bricks and tiles which are specially glazed, the unglazed products, both packaged and unpackaged, constitute his first marketable product or group of products.

(v) (*a*) As used in this subparagraph, the term "gross sales (actual or constructive)" means the total of the taxpayer's actual competitive sales to others of the first marketable product or group of products, plus the taxpayer's constructive sales of the first marketable product or group of products used or retained for use in his own subsequent operations, subject to the adjustments required by paragraph (e) of this section. See (*b*) of this subdivision in the case of actual sales between members of controlled groups and in the case of constructive sales. A "constructive sale" occurs when a miner-manufacturer is deemed, for percentage depletion purposes, to be selling the first marketable product or group of products to himself.

(*b*) In the case of sales between members of a controlled group as to which the district director has exercised his authority under section 482 and the regulations thereunder and has determined the appropriate price with respect to specific sales transactions, that price shall be deemed, for those transactions, to be the actual amount for which the first marketable product or group of products is sold for purposes of this subdivision (v). In the case of all other sales between members of a controlled group, and in the case of constructive

sales, the prices for such sales shall be determined by use of the principles set forth in paragraph (c) of this section, subject to the adjustments required by paragraph (e) of this section. In the case of constructive sales, see paragraph (c)(4) of this section for rules relating to information to be furnished by the taxpayer.

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(5) *Representative schedule method.* The "representative schedule method" is a pricing formula which uses representative finished product prices, penalties, charges and adjustments, established in arms-length transactions between unrelated parties, to determine the market or field price for a crude mineral product. The representative character of a price, penalty, charge, or adjustment shall be determined by applying the principles set forth in paragraph (c) of this section. The representative schedule method is principally intended for use in those industries in which such a schedule-type pricing method is in general use to determine the price paid to unintegrated mineral producers for their crude mineral product. For example, if unintegrated producers of copper concentrate in a particular field or market customarily sell their product at prices which are determined in accordance with a schedule-type pricing formula, consideration will be given to the determination of concentrate prices for integrated copper producers in accordance with the same pricing formula. The representative schedule method shall not be used if it is impossible to determine one or more of the elements in the representative schedule formula by reference to prices, penalties, charges, or adjustments established in representative transactions between unrelated parties. See paragraph (c) of this section for principles determining the representative character of a charge.

(6) *Method using prices outside the taxpayer's market.* Under the "other market method" the taxpayer uses representative market or field prices established outside his markets, provided that conditions there are substantially the same as in his markets. For example, it may be appropriate in a particular case to establish the representative market or field price for pellets containing 60 percent iron which are produced and used in market area X by reference to the representative market or field price for pellets containing 60 percent iron which are produced and sold in adjacent market area Y, provided that conditions in the two marketing areas are shown to be substantially the same.

(7) *Rate of return on investment method.* [Reserved]

(e) *Reductions of sales price in computing gross income from mining*—(1) *Discounts.* If a taxpayer computes gross income from mining under the provisions of paragraph (b) (1) of this section, trade discounts and, for taxable years beginning after November 30, 1968, cash discounts actually allowed by the taxpayer shall be subtracted from the sale price of the taxpayer's ore or mineral. If a taxpayer computes gross income from mining under the provisions of paragraph (c) of this section, any such discounts actually allowed (if not otherwise taken into account) by the person or persons making the sales on the basis of which the representative market or field price for the taxpayer's ore or mineral is to be determined shall be subtracted from the sale price in computing such representative market or field price. If a taxpayer computes gross income from mining under the provisions of paragraph (d) of this section, such discounts actually allowed (if not otherwise taken into account) shall be subtracted

from the gross sales (actual or constructive), and shall not be considered a cost, of the first marketable product or group of products. The provisions of this subparagraph shall apply to arrangements which have the same effect as trade or cash discounts, regardless of the form of the arrangements.

(2) *Purchased transportation to the customer.* (i) A taxpayer who computes gross income from mining under the provisions of paragraph (c) of this section and who sells his ore or mineral after the application of only mining processes but after nonmining transportation shall use as the representative market or field price his delivered price (if otherwise representative) reduced by costs paid or incurred by him for purchased transportation to the customer as defined in subdivision (iii) of this subparagraph. If the transportation by the taxpayer is not purchased transportation to the customer, or if the taxpayer does not sell the ore or mineral until after the application of nonmining processes and if other producers in the taxpayer's marketing area sell significant quantities of an ore or mineral of like kind and grade after the application of only mining processes but after purchased transportation to the customer, the representative delivered price at which the ore or mineral is sold by those other producers reduced by representative costs of purchased transportation to the customer paid or incurred by those producers shall be used by the taxpayer as the representative market or field price for his ore or mineral in applying paragraph (c) of this section. Furthermore, appropriate adjustments shall be made to take into account differences in mode of transportation and distance. When applying this subdivision, the representative market or field price so computed shall not exceed the taxpayer's delivered price less his actual costs of transpor-

tation to the customer. For purposes of this subdivision, any delivered price shall be adjusted as provided in subparagraph (1) of this paragraph.

(ii) If a taxpayer computes gross income from mining under the provisions of paragraph (d) of this section, the cost of purchased transportation to the customer (as defined in subdivision (iii) of this subparagraph) shall be excluded from the gross sales of his first marketable product or group of products (after any adjustments required by subparagraph (1) of this paragraph), and from the denominator of the proportionate profits fraction, so as not to attribute profits to the cost of that transportation. Similar transportation cost adjustments may be made, if appropriate, in the case of other methods of computation which are based on the taxpayer's costs. For the treatment of costs and profits attributable to transportation which is not purchased transportation to the customer as defined in subdivision (iii) of this subparagraph, see paragraph (d) (3) (i) of this section.

(iii) For purposes of this section, the term "purchased transportation to the customer" means, in general, nonmining transportation of the taxpayer's minerals or mineral products to the customer—

(*a*) Which is not performed in conveyances owned or leased directly or indirectly, in whole or in part, by the taxpayer,

(*b*) Which is performed solely to deliver the taxpayer's minerals or mineral products to the customer, rather than to transport such minerals or products for packaging or other additional processing by the taxpayer (other than incidental storage or handling), and

(*c*) With respect to which the taxpayer ordinarily does not earn any profit.

For purposes of the preceding sentence, transportation which is performed by a person controlling or controlled by the taxpayer (within the meaning of paragraph (*j*) (1) of this section) shall be deemed to have been performed in conveyances owned or leased by the taxpayer unless it is established by the taxpayer that the price charged by the controlling or controlled person for such transportation constitutes an arm's-length charge (under the standard described in paragraph (b) (1) of § 1.482-1). The term "purchased transportation to the customer" includes transportation to a warehouse, terminal, or distribution facility owned or operated by the taxpayer, provided that such transportation is performed under the conditions described in the first sentence of this subdivision. A taxpayer will not be deemed ordinarily to earn a profit on transportation merely because charges for the transportation are included in the stated selling price, rather than being separately stated or segregated from other billing. A taxpayer will not be deemed ordinarily to earn a profit on transportation if the rates for the transportation constitute an arm's-length charge ordinarily paid by shippers of the same product in similar circumstances. If a taxpayer computes gross income from mining under the provisions of paragraph (d) of this section, the term "purchased transportation to the customer" refers to transportation which conforms to the other requirements of this subdivision and which is performed to transport the taxpayer's first marketable product or group of products (as defined in paragraph (d) (4) (iv) of this section) rather than to transport minerals or mineral products which do not yet constitute the taxpayer's first marketable product or group of products.

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§ 1.613-5 *Taxable income from the property.*

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(c) *Treatment of particular items in computing taxable income from the property.* In determining taxable income from the property under the provisions of paragraph (a) of this section—

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(4) (i) Selling expenses, if any, paid or incurred with respect to a raw mineral product shall be subtracted from gross income from the property. See subdivision (iii) of this subparagraph for the definition of the term "raw mineral product." For example, the selling expenses paid or incurred by a producer of raw mineral products with respect to products such as crude oil, raw gas, coal, iron ore, or crushed dolomite shall be subtracted from gross income from the property.

(ii) A reasonable portion of the expenses of selling a refined, manufactured, or fabricated product shall be subtracted from gross income from the property. Such reasonable portion shall be equivalent to the typical selling expenses which are incurred by unintegrated miners or producers in the same mineral industry so as to maintain equality in the tax treatment of unintegrated miners or producers in comparison with integrated miner-manufacturers or producer-manufacturers. If unintegrated miners or producers in the same mineral industry do not typically incur any selling expenses, then no portion of the expenses of selling a refined, manufactured, or fabricated product shall be subtracted from gross income from the property when determining the taxpayer's taxable income from the property.

(iii) For purposes of this subparagraph, a product will be considered to be a raw mineral product if (in the case of oil and gas) it is sold in the immediate vicinity of the well or if (in the case of minerals other than oil and gas) it is sold under the conditions described in paragraph (b) (1) of § 1.613-4. In addition, a product will be considered to be a raw mineral product if only insubstantial value is added to the product by nonmining processes (or, in the case of oil and gas, by conversion or transportation processes). For example, in the case of a producer of crushed granite poultry grit, both bulk and bagged grit will be deemed to be a raw mineral product for purposes of the selling expense rule set forth in this subparagraph.

(iv) The term "selling expenses", for purposes of this subparagraph, includes sales management salaries, rent of sales offices, sales clerical expenses, salesmen's salaries, sales commissions and bonuses, advertising expenses, sales traveling expenses, and similar expenses, together with an allocable share of the costs of supporting services, but the term does not include delivery expenses.

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